No. 96-1351

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In the Supreme Court of the United States

OCTOBER TERM, 1996

BERRY F. LAWS, III,
Successor Segregated Fund Trustee,
Petitioner,

v.

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

We demonstrated in our petition that the Court of Appeals decision misapplied a key component of one of the fundamental provisions of the Bankruptcy Code, the 11 U.S.C. § 547(b)(5) improvement-of-position test of the preference section. The Court of Appeals' interpretation of that provision conflicts not only with recognized canons of statutory construction, but also with the interpretations of the provision by numerous other circuits.

In its opposition, UMB ignores that conflict. Instead, in an effort to deflect this Court's scrutiny, UMB glosses over key facts, misstates Petitioner's factual and legal arguments, and attempts an Alice-in-Wonderland explanation of the critical legal error in the Court of Appeal's decision — that kited checks, uniformly recognized by legal authorities as being valueless, somehow rendered UMB a fully secured creditor. As we show below, UMB's diversionary tactics lack substance, and review by this Court is warranted.

1. In arguing that Petitioner has failed to advance any reason why the questions presented in the Petition warrant review (Opp. 6), UMB ignores a point made repeatedly in the Petition: that this case involves a key component of the preference section, one of the fundamental provisions of the Bankruptcy Code. See *Begier* v. *Internal Revenue Service*, 496 U.S. 53, 58 (1990) (preference section promotes the "central policy of the Bankruptcy Code," *i.e.*, equality of distribution).[1] Because the questions presented are of paramount importance under a key provision of a comprehensive federal statutory scheme, they warrant review.

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[1] See 5 COLLIER ON BANKRUPTCY ¶ 547.03[7], p. 547-39 (15th rev. ed. 1996) ("Section 547(b)(5) is a central element of the preference section because it requires a comparison between what the creditor actually received and what it would have received under the chapter 7 distribution provisions of the Code.").

That the Court of Appeals' short-cut in applying Section 547(b)(5) is in conflict with how other circuits have applied the statute only reinforces that conclusion.

2. UMB, an *insider* of Kroh, correctly suspecting that Kroh was engaged in a check-kiting scheme, demanded that Kroh immediately provide it with "good funds" in order to protect it from that scheme's consequences. Pet. 2-3. Kroh complied with its insider's demand and made the $4 million transfer at issue in this case. *Ibid.* This enabled UMB to have no material claim against Kroh outstanding at the commencement of the bankruptcy case, while other unsecured creditors will receive substantially less than twenty-five percent of their claims under Kroh's confirmed plan of reorganization. *Ibid.* As demonstrated in the Petition (*id.* at 5-6), this transfer has all the earmarks of a preference: an insider with valueless collateral (and thus an unsecured creditor) demanding immediate payment from the putative debtor to cover its mounting debts, thereby depleting the bankruptcy estate and preferring that creditor over other unsecured creditors. This transfer therefore directly implicates the "central policy" of equality of distribution imbedded in the Bankruptcy Code.

UMB nowhere addresses those facts, but instead engages in a detailed and irrelevant description of how the general rules of check presentment would function on the facts of this case. Opp. 1-5. However, UMB cites no authority for the proposition that such general presentment rules, which arise primarily under state law, take supremacy over, and constitute sufficient legal authority to otherwise ignore, a federal statute.[2]

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[2] UMB also takes issue with Petitioner's statement that Kroh was "obviously insolvent" at the time of the transfer. Opp. 5. However, Petitioner is challenging summary judgment granted against it and is thus entitled to the presumption that its allegation is true. Moreover, Petitioner plainly can prove this allegation at

3. Section 547(b)(5) of the Bankruptcy Code requires a creditor to return a transfer that made it better off than it would have been "had [it] waited for liquidation and distribution of the assets of the estate" in a Chapter 7 case. *In re Virginia-Carolina Financial Corp.*, 954 F.2d 193, 199 (4th Cir. 1992).

As demonstrated in the Petition, if the transfer in this case had not occurred — *i.e.*, if the October 20, 1986 payment had not been made to UMB and had the $4 million in proceeds from the $7 million Commerce Bank loan been used to pay another creditor instead — the kite would have eventually collapsed, UMB would have had a $4 million unsecured claim as of the commencement of the bankruptcy case, and UMB would not have received payment in full of that claim in a hypothetical Chapter 7 liquidation of an insolvent Kroh.

UMB disputes this straightforward application of the statute by claiming that the $7 million in loan proceeds deposited in an account at one of the banks used in the check-kiting scheme (Commerce Bank) rendered UMB's collateral valuable because it stopped the kite. Opp. 10-11. Not only does UMB's argument contravene established authority, but UMB also falsely claims (*ibid.*) that we have agreed with it.

First, UMB's argument ignores that the statute requires the court to hypothesize what would have happened had the transfer not been made and had the transferred property instead been available for some other estate purpose. See *In re Smith*, 966 F.2d 1527, 1536-1537 (7th Cir. 1992) (because the debtor "could have purchased a yacht or acquired some

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trial: the challenged transfer occurred only approximately four months before the commencement of the bankruptcy case and other unsecured creditors will receive substantially less than twenty-five percent of their claims under Kroh's confirmed *liquidating* plan of reorganization.

other assets instead of paying his debt," the assets of the estate were less than they could have been). Thus, UMB is not entitled to the legal presumption that the loan proceeds would have remained on deposit in the Commerce Bank account and used for no other purpose had $4 million of those proceeds not been wire-transferred to UMB as it demanded. Not surprisingly, UMB cites *no* authority in support of such a presumption. Opp. 10-11.

Second, the wisdom of the absence of such a presumption is underscored by the very facts of this case. Had UMB not insisted on the immediate transfer of the $4 million, Kroh could easily have transferred those loan proceeds to some other person or entity for some other estate purpose. Kroh could have accomplished this immediately in exactly the same way it transferred the $4 million to UMB — by wire-transfer. It would thereby have prevented those funds from remaining on deposit and from rendering UMB's worthless collateral valuable.[3]

Third, UMB's claim (Opp. 10) that Petitioner agrees with its position that the deposit of the $7 million loan proceeds in the Commerce Bank account rendered its collateral valuable is simply wrong. The out-of-context passages from Petitioner's Court of Appeals brief on which UMB relies state that Petitioner viewed the $4 million wire transfer to UMB to be the pivotal event, not the deposit in Commerce Bank of the $7 million in proceeds. See Opp. App. 5A. Just as important, UMB ignores Petitioner's unambiguous statement in its reply brief in the Court of Appeals (at page 16) that

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[3] This, of course, presupposes that the $7 million of loan proceeds were deposited in the Commerce Bank account, which was one of the accounts Kroh was using in the check-kiting scheme. However, that was happenstance. Kroh just as easily could have directed Commerce Bank to wire-transfer the $4 million directly to UMB or to an account at another bank that was not being used in the check-kiting scheme.

"UMB cites absolutely no authority that the kite ended and the debt was repaid merely by KBDC's deposit of money into Commerce Bank on Monday morning. Contrary to UMB's claims, the [Petitioner] does not acknowledge the end of the kite by that act."[4]

4. UMB cites the fact that none of the kited checks was ever returned as evidence of the checks' value as collateral. Opp. 11-12. But UMB cites (*ibid.*) no 11 U.S.C. § 547(b)(5) authority in support of its argument. As we indicated in the Petition and above, that argument completely ignores the results of the required application of 11 U.S.C. § 547(b)(5), contrary authority, and UMB's very own actions in this case.

Kited checks are worthless at the time they are presented, even though the fact of their worthlessness is not generally known until the kite collapses (which was prevented in this case by the very transfer in question). See *United States* v. *Sher*, 661 F.2d 34, 35 (3d Cir. 1981) ("a kited check is 'overvalued' because it is represented to be worth its face value, when in fact it is worthless, since it is not supported by funds on deposit in the account on which the check is drawn"); *Stevens* v. *United States*, 227 F.2d 5, 6 (8th Cir. 1955) (describing check kiting as "cashing worthless checks

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[4] Petitioner was just as clear on page 17 of the same reply brief:

> KBDC was involved in a check kiting scheme that could float no higher on October 17, 1986, when UMB changed the rules and told KBDC "we want good funds." At that point, KBDC injected $7 million of real money into the system on Monday morning, October 20, 1986. It wired $4 million directly to UMB; the funds deposited were "*good* funds" but were *not* available for the debtor to withdraw because those funds were applied to eliminate the kiting extension of credit. The kite stopped then — not before.

(emphasis in original).

to procure funds for deposit to cover previous checks, there being no reasonable prospect of paying"). The only way kited checks can obtain any value is when good funds are actually injected into and remain in the banking system to cover them. In this case, that did not occur until UMB insisted on the $4 million transfer in question.[5] The transfer, in fact, depleted Kroh's bankruptcy estate by $4 million. See, *e.g.*, *In re Smith*, 966 F.2d at 1536-1537.

A common-sense proof of the worthlessness of UMB's "collateral" is UMB's own actions. If UMB were fully secured by its possession of such checks, there would have been no need to demand, as it did, that Kroh provide it with "good funds." Indeed, the concept of "good funds" has no meaning if the checks were, in fact, collateral worth their face amount. The kited checks were worthless by definition and they remained so until the $4 million wire-transfer to UMB.

5. As we noted in our Petition (at 6, 14-18), the Eighth Circuit held — contrary to the law in at least two other circuits (*In re Montgomery*, 983 F.2d 1389 (6th Cir. 1993); *In re Smith*, 966 F.2d at 1532) — that routine advances against uncollected balances can never constitute a debt for preference purposes under 11 U.S.C. § 547(b)(2). We submitted (and still submit) that this conflict should be resolved in favor of the positions of the Sixth and Seventh Circuits, and in fact, UMB does not even attempt to counter the reasoning of those other circuits. Opp. 7-8. However, we made clear (Pet. 15) that this question was secondary to and should be considered only if certiorari is granted with respect to the 11 U.S.C. § 547(b)(2) question. That remains

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[5] The funds by which the kited checks were ultimately paid involved a new injection of capital (*i.e.*, $4 million on October 20) into the floating system of bad checks; these new funds were independent of and unrelated to the kited checks. Therefore, such new funds were not "proceeds" of the kited checks.

the case. The Court's scrutiny of the 11 U.S.C. § 547(b)(5) issue should not be deflected by UMB's attempt (Opp. 7-8) to cast the 11 U.S.C. § 547(b)(2) issue as preeminent — a view we have never endorsed.

CONCLUSION

The Court should grant a writ of certiorari.

Respectfully submitted,

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